

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

FCC 96-93

In the Matter of
Federal-State Joint Board
on Universal Service

)
) CC Docket No. 96-45
)

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EXECUTIVE SUMMARY

The companies providing local service to the vast majority of customers in the state of Texas -- GTE and Southwestern Bell (SWB) -- have proposed to raise basic rates by approximately \$11 per month. Such a dramatic increase in monthly rates for core services was certainly not what the public was promised when the 1996 Act was passed.

The proposals to increase basic rates fail a wide range of legal tests.

- (1) They violate the explicit provision of the law which require core services bear, at most, only a reasonable share of joint and common costs and that competitive services not be cross-subsidized.
- (2) They lack an evidentiary basis establishing that local rates do not cover their costs.
- (3) They are based, at least in part, on erroneous regulatory theories of guaranteed recovery of costs that violate fundamental principles governing just and reasonable rates and have been consistently rejected by the courts.
- (4) They ask the FCC to enter into retail ratemaking in a way that far exceeds the FCC's legal authority to do so.
- (5) They impose surcharges on end-user bills that are contrary to the clear language in the law which requires that service providers make a contribution to universal service costs.

The proposals to raise monthly rates for core services are not only contrary to the law, they are also bad public policy and especially bad universal service policy (which was, after all, intended to be the purpose of this proceeding). Such an increase would result in a net increase in the telephone bills of the residential ratepayers, and would fall most heavily on the very groups who are least able to afford telephone service.

Although assurances have been given that rate rebalancing will be revenue neutral in the aggregate, these claims and promises are doubtful at best.

- (1) To the extent that they rely on market forces to pressure companies to pass through cost reductions, neutrality will be as imperfect as the competition in telecommunications markets. In the long distance market, competition is far from perfect and in the local market it is virtually non-existent.
- (2) To the extent that revenue neutrality depends on regulation of prices, it must be recognized that pricing flexibility and deregulation in many states has limited the ability of commissions to ensure pass throughs.

Claims of revenue neutrality are suspect for other reasons. The proposals by SWB and GTE drive a wedge between the rate reduction for non-core services and the rate increase for core services by adding surcharges directly to customer's bills. Claims that customers will see lower bills or are economically better off are doubtful in light of the surcharges, which would add as much as \$5 per month to individual bills.

Even if rates for non core services are lowered in an amount equal to the aggregate increase in core services, the distribution of the rate increases and decreases will not be even and the impact will be contrary to intentions of the Act.

- (1) For every \$1 of increase in monthly rates for core services, the poorest 40 percent of the population suffers a \$.25 increase in its telecommunications bill; while the richest 20 percent enjoy a net decrease of \$.46
- (2) The households that suffer the net increase in their bills are the most in need; households headed by persons under 25, persons over 65, and females.
- (3) These are the very households most likely to lose telephone service as a result of a rate increase. For example, households with incomes below \$20,000 per year represent about 36 percent of all households in the Texas, and represent over 85 percent of all households without telephone service.

Imposing rate increases on this group simply defies logic as a part of a universal service proceeding and expansion of the lifeline program is an ineffective response to a large increase in monthly charges for core services.

- (1) It does not provide relief for the working poor and lower middle class -- over one-quarter of the population with incomes between poverty and median income -- who would be paying a much larger part of their income for core services upper income households
- (2) Participation in lifeline programs is quite low, so that many of the households who are eligible are unlikely to receive the benefits.
- (3) Those households that do participate would receive a waiver only for the federal subscriber line charge but little relief is offered for state rate rebalancing.

I. INTRODUCTION

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In initial comments,¹ the Texas Office of Public Utility Counsel (OPUC) stressed the fact that the strong commitment made by Congress to providing high quality service at just, reasonable and affordable rates was not adequately reflected in the Notice of Proposed Rulemaking.² Instead of reaffirming this commitment and taking a broad and inclusive view of affordability, the Notice wandered into several discussions of mechanisms to increase rates for basic service.³ Unfortunately, the vast majority of industry commentators have seized upon the flaw in the Notice to recommend massive rate increases for core services.⁴

The companies providing local service to the vast majority of customers in the state of Texas -- GTE⁵ and Southwestern Bell (SWB)⁶ -- have proposed to raise basic rates by approximately \$11 per month. The long distance companies (IXCs) serving the vast majority

¹ "Initial Comments of the Texas Office of Public Utility Counsel," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter OPUC).

² OPUC, para. 1-10.

³ OPUC, para. 44-47.

⁴ The concept of core services replaces the concept of basic service with the passage of the 1996 Act.

⁵ "GTE's Comments," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter GTE), does not state any specific estimates of the resulting increases in basic rates, but it presents one of the most aggressive proposals to raise and rebalance rates which inevitably would lead to large increase in basic rates. The proposal includes dollar-for-dollar revenue replacement (p. 9), immediate and total rate rebalancing for access, toll, business and enhanced services (p. 14), an increase in the EUCL (p. 15), deaveraging of the EUCL (p. 15), complete recovery of all embedded costs including depreciation reserves (p. 16), and a surcharge placed on ratepayers bills to recover universal service fund costs (pp. 16-17).

⁶ "Comments of Southwestern Bell Telephone Company," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter, SWB), proposes an explicit affordability benchmark which, as described below, would result in rate increases of at least \$8 per month for core services in its service territory.

of customers in the state -- AT&T,⁷ Sprint,⁸ and LDDs⁹ -- appear to endorse this proposal.¹⁰

A dramatic increase in monthly rates for core services was certainly not what the public was promised when the 1996 Act was passed. These reply comments urge the FCC and the Joint Board to reject any increases in the monthly rates for core services because such an increase violates both the letter and the spirit of the law.

- o First, the proposals of the industry ask the FCC to do something that (1) violates the explicit provision of the law, (2) lack an evidentiary basis in this proceeding, (3) goes far beyond the current interpretation of just and reasonable rates, (4) exceeds the FCC's legal authority, and (5) excuses telecommunications service providers from contributing to the support of universal service.

⁷ "Comments of AT&T Corporation," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter AT&T) advocates an increase of \$3.50 per month in the EUCL (p. 16). It also advocates a reduction in access charges equal to approximately \$11 per month, arguing that the difference will not be reflected in residential ratepayer bills, although it would not preclude rate rebalancing (pp. 6-7). AT&T's affordability standard is determined only by penetration rates (p. 6), as long as penetration does not decline, core service rates can rise, and therefore ultimately would allow much larger rate increases.

⁸ "Comments of Sprint Corporation," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Sprint) advocates requiring states to rebalance rates up to a federal benchmark (p. 5). Sprint extends rate rebalancing well beyond access and toll, however, arguing that states must rebalance business and intrastate access charges and adopt state subscriber line charges (pp. 19-20). For rural areas, the rate increase would include at least a \$3 increase up to the national urban average, plus at least a \$2.50 increase in subscriber line charges.

⁹ "Comments of LDDS WorldCom," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter LDDS), argues for an increase in the subscriber line charge and the removal of all "non-cost-based" expenses from access charges, which the companies would "be free to either "absorb internally" or "pass them along to consumers in their retail rates" (p. 5).

¹⁰ MCI, alone, among the major long distance companies does not support an increase in the EUCL. "MCI Comments," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter MCI), pp. 13-14.

- o Second, the proposals to dramatically increase the monthly charges for core services are not only contrary to the law, they are bad public policy and especially bad universal service policy (which was, after all, intended to be the purpose of this proceeding).
- o Such an increase would result in (1) a net increase in the telephone bills of the residential ratepayers and (2) would fall most heavily on the very groups who are least able to afford telephone service.

Section II of these reply comments demonstrates the lack of a legal basis for this rate rebalancing. Section III briefly lays out the approach to rate rebalancing being advocated by the industry and estimates its magnitude, focusing on the SWB proposal, and demonstrates the adverse impact of the proposed rate restructuring.

II. THE LACK OF A LEGAL BASIS FOR AN INCREASE IN MONTHLY RATES FOR CORE SERVICES

A. Claims About the Existence of a Subsidy Are Based on a Flawed Theory of the Allocation of Common Costs

The vast majority of the rate increase for core services is driven by the intention of the industry to recover loop cost in a basic monthly charge paid by end-users. As noted in our initial comments, this is inconsistent with the joint and common cost language of Section 254(k).¹¹ Section 254(k) requires that core services recover, at most, a reasonable share of joint and common costs. Allocation of 100 percent of loop costs to core services is not reasonable in our view and inconsistent with the law.

¹¹ OPUC, para. 19-2.

It is not only consumer advocates who echo this view of the loop,¹² but even some local companies point out that CCI charges represent the recovery of joint and common costs.¹³ State regulators also take this view.¹⁴

¹² "Comments of the National Association of State Utility Consumer Advocates," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter NASUCA), p. 17); "Initial Comments of the Office of the Ohio Consumers' Utility Counsel," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter OCC), p. 3.

¹³ "Comments of Bell Atlantic," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Bell Atlantic), p. 11-12 and "Comments of NYNEX," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter NYNEX), p. 3. It is ironic to note that Sprint (p. 14-15) claims that the Benchmark Cost Model treats loop as a common cost for enhanced services, yet, fails to accept the fact that loop is a common cost for long distance services. Similarly, it is ironic that PacBell invokes *Smith v. Illinois*, as a case that established the principle of cost sharing between the federal and state jurisdictions. PacBell fails to note that loop facilities should be subject to the same sharing principles. The state regulators believe this principle requires long distance to share in common costs such as loop (Maine, at al., p. 18).

¹⁴ "Comments of the State of Maine Public Utility Commission, the State of Montana Public Service Commission, the State of Nebraska Public Service Commission, the State of New Hampshire Public Utilities Commission, the State of New Mexico State Corporation Commission, the State of Utah Public Service Commission, the State of Vermont Department of Public Service and Public Service Board, and the Public Service Commission of West Virginia" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Maine, et al.), p. 18; "Comments of the Idaho Public Service Commission" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Idaho), p. 17); "Comments of the Public Utility Commission of Texas" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Texas), p. ii; "Initial Comments of the Pennsylvania Public Utility Commission to the Notice of Proposed Rulemaking and Order Establishing Joint Board" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Pennsylvania), p. 7; "Comments of the Florida Public Service Commission" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Florida), p. 22; "Initial Comments of the Virginia Corporation Commission," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Virginia), p. 5; "Comments of the Staff of the Indiana Utility Regulatory Commission" In the Matter of Federal-

B. Claims About the Magnitude of the Subsidy Lack an Evidentiary Basis

The proposed increase in monthly charges for core services lack an evidentiary basis in this proceeding.¹⁵ The industry claim that core services are subsidized has not been demonstrated. The FCC has never conducted a proceeding to document this assertion.¹⁶

In fact, when states review these costs in litigated proceedings, they find exactly the opposite. NASUCA lists nine states, which account for one-third of the population, in which cost studies have been found to result in "inflated costs for basic exchange service."¹⁷ In fact, the most recent investigation by a state commission has concluded that residential rates recover their costs.¹⁸ In rejecting U S W's claim that residential rates are subsidized, the Commission held "There simply is no local subsidy."¹⁹

Although several industry commentators refer to ARMIS book costs (e.g. US West,²⁰ SWB²¹), these costs have not been subject to regulatory scrutiny and they have not been found to be prudent by any regulatory commission. A number of companies have put forward a

State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter Indiana), p. 9.

¹⁵ See the opening statement of Commissioner Sharon Nelson of Washington to the Joint Board, April 12, 1996, which challenged the data purporting to show a subsidy.

¹⁶ Indiana, p. 6, identifies the analytic steps through which the Commission must go to establish that evidentiary basis.

¹⁷ NASUCA (p. 14) identifies the following states in which the costs are vastly overstated -- Maryland, Pennsylvania, Florida, New Hampshire, Maine, Washington, Indiana, Iowa, and California.

¹⁸ "Fifteenth Supplemental Order: Decision and Order Rejecting Tariff Revisions: Requiring Relief," Docket No. UT-950200, Washington Utilities and Transportation Commission v. U S West Communications Inc., April 11, 1996 (hereafter, Washington).

¹⁹ Washington, p. 10.

²⁰ "Comments U S West Inc. In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter USW), Schedule 3.

²¹ SWB, Attachment 5.

Benchmark Cost Model as a tool for establishing universal service fund needs.²² This model raises serious questions about the unscrutinized ARMIS costs that the local companies use to identify the magnitude of rate rebalancing and revenue replacement they demand.

For example, Table 1 depicts the wide range of cost claims for Washington now before the FCC and shows that a similar problem is likely to apply to Texas. Commissioner Nelson referred to a cost finding in the state of Washington of \$10.50 per month.²³ USW shows ARMIS costs of \$33.40.²⁴ Benchmark costs are estimated at between \$24.48 and \$17.02.

ARMIS embedded costs in Texas are very close to those for Washington, as are the Benchmark costs. Claims about costs in Texas should be subject to the same close scrutiny as those claims in Washington.

The problem of using unverified cost information supplied by the LECs is compounded by the alarming trend by these companies of cloaking pricing information behind "proprietary" and "confidential" labels. This practice should be rejected. Rate setting with secret or unverified information should be avoided; whereas, reliance on publicly available data that has been scrutinized and more easily audited brings integrity to the process. In any event, the FCC is certainly in no position to reach any evidentiary conclusions about costs of core services for purposes of retail ratemaking on the basis of the record before it.

²² The model was developed jointly by MCI, Sprint, USW and NYNEX Benchmark Cost Model, CC Docket No. 80-286, December 1, 1995 (hereafter, BCM).

²³ Washington, p. 10

²⁴ USW, Schedule 3

TABLE 1
DISPARITIES IN COST ESTIMATES

	LITIGATED	ARMIS EMBEDDED	BENCHMARK ARMIS FACTOR	BENCHMARK MCI FACTOR
WASHINGTON	10.50	33.40	24.48	17.02
TEXAS	N/A	35.06	25.14	18.23

SOURCES: "Fifteenth Supplemental Order: Decision and Order Rejecting Tariff Revisions: Requiring Relief," Docket No. UT-950200, Washington Utilities and Transportation Commission v. U S West Communications Inc., "Comments U S West Inc.," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996, Schedule 3. MCI, Sprint, USW and NYNEX Benchmark Cost Model, CC Docket No. 80-286, December 1, 1995.

C. Claims to Guarantee Recovery of Obsolete and Uneconomic Plant Violate Well Established Principles of Ratemaking

Several of the local exchange companies have proposed to either increase local rates or levy surcharges on rates to recover their depreciation reserves.²⁵ SWB proposes to recover these costs over a five year period. The result is a proposed surcharge of \$500 million per year that would be equal to one-third of the "recurring subsidy."²⁶ Bell South puts the figure at 10 percent of the total, or \$200 million, if amortized over eight years.²⁷

These claims rest on a version of the regulatory compact between stockholders and ratepayers that never existed. The guarantee of recovery that LECs claim is an ex post effort to recover assets and recoup actions for which management bears responsibility and stockholders

²⁵ SWB, p. 17; Bell South, p. 7; GTE, p. 16.

²⁶ SWB, Attachment 5.

²⁷ Bell South, p. 7.

have already been handsomely compensated.²⁸ To compensate companies for uneconomic investments by surcharges on ratepayers bills, when they have already been compensated for the risk of those investments, constitutes a double recovery of costs which violates the fundamental principles of just and reasonable rates.²⁹

Far from guaranteeing this complete recovery of all costs rendered uneconomic by competition, current law places the burden of the risk of competition squarely on the shoulders of utilities and shields them only from the most dire financial outcome -- bankruptcy. It is hard to imagine that the two largest local companies serving Texas, with returns on equity and market-to-book ratios well above the national average, will convince a court that they would be pushed over the brink of financial ruin unless they are compensated for their uneconomic plant. As Table 2 shows, the extremely strong financial performance of local exchange companies undermines any claims that failure to recover obsolete and uneconomic investment will threaten the financial soundness of these companies.³⁰

²⁸ Office of Public Utility Counsel, "Comments for Workshop No. Five," Rulemaking on Transmission Pricing and Access, Before the Public Utility Commission of Texas, Project No. 14045.

²⁹ *Id.*, p. 7.

³⁰ OCC, p. 9, notes the excess profits of some local exchange companies.

TABLE 2.
FINANCIAL PERFORMANCE OF THE LOCAL EXCHANGE INDUSTRY

	RETURN ON EQUITY	MARKET-TO-BOOK
NATIONAL AVERAGE (BUSINESS WEEK 1,000)	15.7	3.3
AMERITECH	28.6	4.6
BELL ATLANTIC	28.1	4.4
BELL SOUTH	13.2	3.4
GTE	22.8	3.8
NYNEX	17.9	3.7
PACTEL	47.9	5.5
SWB	30.8	5.5
U S WEST	34.1	4.5

SOURCE: Business Week, March 25, 1996.

D. Retail Rate Rebalancing Exceeds the Commission's Authority

The extensive rate rebalancing that the local exchange companies are seeking to have the FCC impose on the states exceeds the legal authority of the Commission under the 1996 Act.³¹

The ratemaking provision of the 1996 Act addresses only the issue of wholesale and resale tariffs, which set the prices that telecommunications providers will pay one another for the use of inputs purchased from each other. These provisions do not transfer authority over retail rates paid by end-users (output prices) to the FCC.³²

³¹ Even the two local exchange companies that did not argue for rate increases recognize that the FCC has limited authority to set local rates for core services (PacBell, pp. 19-20; NYNEX, p. 4).

³² Even "Comments of Pacific Telesis," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 (hereafter PacTel) points out the limitations on the authority of the FCC to interfere with intrastate rate making (pp. 19-20). Indiana, p. 9, also notes that the limitation on FCC authority

Even in the area of input prices, the law preserves the rights of the state to exercise discretion in the setting of prices.³³ The states can generally adopt approaches to pricing that are not inconsistent with the policy adopted by Congress; they are not required to price precisely as the FCC orders.³⁴ For the FCC to order rate rebalancing would run directly counter to the intent of the legislation.

Retail rate setting is within the jurisdiction of state commissions. The Act clearly states that it has no implied preemptive effect and that it does not modify, impair, or supersede state of local law unless expressly so provided in the Act.³⁵ There is no express provision preempting state commissions from exercising their authority over retail rate setting.

Not only is the prescription of specific rates beyond the legal authority of the FCC, but a federal effort to impose rate rebalancing is contrary to market principles. For example, NYNEX points out that competitive businesses apply a wide variety of approaches to recovering joint and common costs in the costs of the goods and services they sell.³⁶ Sprint implicitly acknowledges this principle when it points out that shared costs are recovered in prices and the ability to do so depends upon market conditions.³⁷ Therefore, there is no grounds for the Commission to claim that only one treatment of joint and common costs is consistent with the competitive intentions of the Act.

The Act preserves the authority of the states to tailor the general policy for implementing universal service and local competition to the unique circumstances of each state. Earlier

³³ Section 251(d)(3), 252(d), 253(b), 254(f).

³⁴ OCC, p. 5, notes the permissive nature of the authority granted the FCC to oversee the transition to a more competitive market.

³⁵ Section 601(c)(1).

³⁶ NYNEX, pp. 4-5.

³⁷ Sprint, pp. 14-15.

versions of the bill had more pre-emption language with respect to retail ratemaking which were taken out of the conference report. These two factors fly in the face of the pre-emption being advocated by the industry.

E. The Proposed Line Item Surcharges on End User Bills is Contrary to the Requirement That Service Providers Contribute to Universal Service

The surcharges suggested by SWB,³⁸ GTE,³⁹ and others⁴⁰ for interstate customer costs, under-depreciated plant and the universal service fund in general, are inconsistent with the Act's mandate in Sections 254(b)(4) and 254(d) that telecommunications providers (not customers) contribute to universal service.⁴¹ The Act explicitly states and the conference report reiterates⁴² that it is the service providers who bear this obligation. If the FCC requires that a line item charge is placed on the customers bill reflecting surcharge for universal service, the telecommunications provider would be completely excused from any contribution.⁴³

³⁸ SWB, p. 19.

³⁹ GTE, p. 17.

⁴⁰ USW, p. 2; AT&T, p. 8.

⁴¹ NASUCA, p. 15.

⁴² Conference report, p. 131.

⁴³ Rather than surcharging customers, telecommunications service providers may choose, for competitive reasons, to absorb the costs associated with the contribution for universal service.

III. ESTIMATING THE MAGNITUDE OF REVENUE SHIFTS

A. The Industry Argument for Rate Increases

As noted above, the increases in monthly charges for core services are driven primarily by the argument that the cost of the loop should be charged directly to end-users, rather than being recovered in the costs for long distance and enhanced services, as they presently are.⁴⁴ Under this erroneous view of the rate structure, ratepayers who receive core services that do not reflect 100 percent of loop costs are being subsidized. In the aggregate, those ratepayers who buy a small amount of enhanced or long distance services are the recipients of a subsidy. Ratepayers who buy a lot of enhanced and long distance services are the source of a subsidy.

The LECs also claim that this rate structure cannot be sustained in the face of competition because competitors will go after the services priced above cost, thereby eliminating the availability of funds to support below-cost pricing of other services or areas.⁴⁵ The LECs demand that they be kept whole in the transition to competition. If the charges that long distance companies pay for the use of the loop are reduced or competitors are given access to network facilities at anything less than the book costs of the LECs, they want to raise rates for core services dollar-for-dollar or be compensated from a universal service fund for their losses.⁴⁶

The LECs and IXCs agree that there is a "justifiable" subsidy that they want to make explicit.⁴⁷ They argue that basic service rates have been kept low in high cost (primarily rural

⁴⁴ The Notice, para 112-115, laid out this argument without stating the opposing point of view.

⁴⁵ USW, p. 4; Pactel, p. 12; NYNEX, p. 8.

⁴⁶ SWB, p. 3; USW, p. 12.

⁴⁷ For example, USW, p. 10, shows a bottom figure of \$4 billion using the MCI/Hatfield model, that assumes \$1 billion in rate increases. MCI, Appendix A, puts the figure at \$5 billion.

areas) by overpricing other services in other areas. They believe that part of this subsidy should be maintained and made explicit.

Although the long distance companies agree that they are being overcharged, they do not agree entirely about where the money goes. The IXC's believe that a substantial part of the money they pay to the LEC's pays not for a core service subsidy, but rather for the inefficiency of the local exchange companies in the form of excess profits, overbuilt plant, and other inefficiencies.⁴⁸ The long distance companies argue that in a competitive market excess profits and the costs of inefficiencies would not be recoverable.

B. The Magnitude of Rate Increases Would be About \$11 Per Month

1. Complete Rate Rebalancing

Both local and long distance companies put the total amount of the unjustified "subsidy" in the range of \$13 billion.⁴⁹ Shifting these costs onto core services would result in increases of approximately \$10.80 per month (\$13 billion/100 million residential lines/12 months).

2. SWB'S Percent of Income Cap on Rates

Several LECs recognize that an increase of this order of magnitude might be considered a threat to universal service. They propose to establish a rate cap, short of full rate rebalancing, to preserve affordability.

The United States Telephone Association suggests that an affordability benchmark of approximately 1 percent of income be used.⁵⁰

⁴⁸ MCI, pp. 3, 10; AT&T, p. 7.

⁴⁹ MCI, p. 15 refers to \$14 billion. USW (p. 10), shows a figure of \$11.6 billion calculated assuming a basic monthly rate of \$20. This implicitly assumes an increase in basic monthly rates of approximately \$1.3 billion. The implicit amount of the so-called subsidy is \$13 billion.

⁵⁰ "Comments of the United States Telephone Association," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC

The impact of these price increases should be examined in the context of the customer's overall expenditures, interstate and state charges, for universal service to determine their impact on affordability.⁵¹

^{*/} For example, a total expenditure of \$28 for telephone service represents approximately one percent of the national median household income for the U.S. (Total expenditure of \$18 represents approximately .6 percent of median household income levels). Given that today Americans spend, on average, approximately 2 to 2.5 percent of income on total telecommunications services and approximately .6 percent of income on basic local exchange service, an average expenditure level of one percent of income for universal services is a very reasonable expectation.⁵¹

As depicted in Table 3, SWB proposes to raise local rates to an amount equal to 1 % of the median household income for a state.⁵² All rates in the state would be moved up to 1 % of income.

Table 3 shows that dramatic impact that this would have on rates in Texas. The analysis is conducted using year-end 1994 income and prices. The state-wide average increase in basic monthly charges for core services in SWB areas would be approximately \$8.70. Rate increases would be much larger in the rural exchanges (over \$10 per month) and smaller in the largest urban exchanges (around \$7 per month).

96-93, CC Docket No. 96-45, April 12, 1996 (hereafter USTA) uses a 1 percent of income benchmark, as does SWB. CTE embraces the concept of an affordability benchmark and parts of the USTA proposal.

⁵¹ USTA, pp. 16-17.

⁵² SWB, Attachment 4.

TABLE 3

CURRENT RATES AND RATE INCREASES UNDER A 1 PERCENT OF INCOME AFFORDABILITY BENCHMARK

SOUTHWESTERN BELL

RATE GROUP	RES. SUB	BASIC RATE	TAX, 911	TOTAL COST	1 % OF INCOME	RATE INCREASE
1	331436	8.15	6.55	14.70	24.94	10.24
2	431335	8.35	6.55	14.90	24.94	10.04
3	398009	8.80	5.47	14.27	24.94	10.67
4	768404	9.10	6.91	16.01	24.94	8.93
5	511195	9.35	6.65	16.00	24.94	8.94
6	858102	9.85	6.63	16.48	24.94	8.46
7	647623	10.40	7.24	17.64	24.94	7.30
8	1058599	11.05	6.21	17.26	24.94	7.68

SWB

AVG.	5004703	9.68	6.55	16.23	24.94	8.70
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GTE/CONTEL

AVG.	1040000	7.35	6.55	13.90	24.94	11.04
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STATEWIDE

TOT	6044703	8.02	6.55	14.57	24.94	10.37
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SOURCE: National Association of Regulatory Utility Commissioners, Bell Operating Companies Exchange Service Telephone Rates, December 31, 1994, for lines and basic rates for Southwestern Bell. Public Utilities Commission of Texas, PUC Annual Report, Regulated Utilities in Texas and Texas Telephone Rates, for GTE and Continental. McMaster, Susan E. and James Lunde, Reference Book: Rates, Price Indexes, and Household Expenditures for Telephone Service (Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, November 1995), Appendix 2 for Tax, 911, Touchtone. The statewide average is assumed for rate groups 1 and 2 and for GTE and Continental. The one percent of income number is \$1 higher than that estimated by "Comments of Southwestern Bell Telephone Company," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996, Attachment 4, to account for income growth from 1993 average to year-end 1994 income, which is the time period for the rates.

Rate increases in GTE service territories would be even larger.⁵³ Under this model, rate increases would be on the order of \$11. The resulting state-wide average for the lines served by SWB and GTE would be over \$10. The remaining 7 percent of lines in the state would certainly see increases of this order of magnitude or larger.⁵⁴

SWB also suggests that the affordability benchmark could be the lesser of 1 percent of income or cost and that rates would be lowered if they exceed the benchmark. This is not likely to provide relief in Texas, however, as Table 4 shows.

TABLE 4
ESTIMATING THE MONTHLY COSTS IN LOW COST EXCHANGES

STATEWIDE ARMIS EMBEDDED COST	35.06
STATEWIDE ARMIS BENCHMARK COST	25.14
ARMIS BENCHMARK LOWEST COST AREA	15.33
ESTIMATED EMBEDDED COSTS, LOWEST COST AREA $[15.33 \times (35.06/25.14)]$	21.38
TAXES + 911	2.71
MONTHLY COST	24.09

SOURCE: See Table 1.

Even in the least cost exchanges to serve, SWB claimed costs (plus taxes, 911 charges and other charges) are likely to exceed the 1 percent of income cap. Data from the ARMIS file and the benchmark cost model suggests this conclusion. Table 4 shows data on claimed embedded costs on a statewide basis compared to BCM costs on a statewide density zone basis. On a statewide basis, claimed embedded costs exceed benchmark costs by almost 40 percent.

⁵³ GTE/Contel rates throughout the state are relatively uniform, falling in the range of \$7.10 to \$7.65. A weighted average is presented in the table, coupled with the state-wide average for taxes, touchtone 911 and other charges.

⁵⁴ Public Utilities Commission of Texas, PUC Annual Report, "Regulated Utilities in Texas and Texas Telephone Rates," shows that rates for these companies are generally lower than for the larger companies.

If this proportion holds for low cost areas, then monthly costs in those areas will be close to the 1 percent of income limit.⁵⁵

SWB has also suggested a surcharge to be placed on bills to amortize its claimed depreciation reserve.⁵⁶ This amounts to approximately \$3 per line per month for five years. It would appear that the surcharge does not fall under the cap. Thus, the rate increase could be \$3 higher than depicted in Table 3.

C. The Distributive Impact of Rate Rebalancing

1. The Burden of Rate Increases Falls Most Heavily on Low and Lower Middle Income Groups

SWB and the other companies that have tried to set up affordability benchmarks have totally misconstrued the concept of the burden of telephone rates. Some companies pick a target price in dollar terms.⁵⁷ Others pick a target price in terms of a percent of median income, either state-wide⁵⁸ or nationwide⁵⁹. Implicitly and explicitly they argue that rates should be set at this level.⁶⁰

⁵⁵ In fact, the authors of the BCM model feel that the costs provided in the first benchmark study overestimate the costs in low density, rural areas. Therefore, the disparity between claimed embedded costs and benchmark costs in high density urban areas is likely to be greater than implied in the available data because the BCM state-wide average is overstated.

⁵⁶ SWB, Attachment 6.

⁵⁷ MCI (p. 4), AT&T (Appendix B), and Florida, p. 5, use \$20. Sprint refers to national urban average price (p. i).

⁵⁸ SWB, Attachment 4.

⁵⁹ USTA, pp. 6-7.

⁶⁰ Once a benchmark price is established, the company providing the service cannot make claims on the universal service fund for any revenues lost because rates are below the benchmark. This creates pressures to raise rates to that level. All of the local companies have requested either rate rebalancing or pricing flexibility (NYNEX, p.8) to accomplish the increase in rates. Thus, it seems clear that the benchmarks will be the target prices that local companies will seek to impose.

This approach misses the whole point of burden analysis. If a low income family is charged one percent of median state-wide income for telephone service, it is actually paying a much higher percentage of its income for telephone service.

Table 5 demonstrates this problem with data from late 1994 for Texas. It shows the midpoint and endpoint of income for households in 14 income groups, ranging from those with incomes below \$5,000 to those with incomes above \$75,000. It calculates one percent of the mid-point and end-point for each income category.

For example, a monthly rate for telephone service of 1 percent of income for a household at the midpoint of the group of households with incomes below \$5,000 would be approximately \$2.08 per month. If this household were forced to pay one percent of the statewide median, it would be paying almost 12 percent of its income for telephone service. If the household had an income of \$5,000, it would be paying roughly 6 percent of its income for telephone service. All households with income up to approximately \$30,000 per year would be paying more than one percent of their income for telephone service, if they were forced to pay 1 percent of the statewide median.

TABLE 5:
INCOME AND TELEPHONE RATES AS A PERCENT OF INCOME

	% OF ALL HH	# OF HH	EST. POINT	INCOME	1 % OF INCOME	MEDIAN RATE AS A % OF INCOME	# OF HH ABOVE 1%
LT 5000	5.65	369.68	midpoint	2,500.00	2.08	11.97	369.68
			endpoint	5,000.00	4.17	5.99	
5 TO 7499	5.65	369.68	midpoint	6,300.00	5.25	4.75	739.37
			endpoint	7,500.00	6.25	3.99	
7500 TO 9999	5.29	345.94	midpoint	8,750.00	7.29	3.42	1,085.31
			endpoint	10,000.00	8.33	2.99	
10000 TO 12499	6.28	410.38	midpoint	11,250.00	9.38	2.66	1,495.69
			endpoint	12,500.00	10.42	2.39	
12500 TO 14999	4.98	325.59	midpoint	13,750.00	11.46	2.18	1,821.29
			endpoint	15,000.00	12.50	2.00	
15000 TO 19999	7.99	522.31	midpoint	17,500.00	14.58	1.71	2,343.59
			endpoint	20,000.00	16.67	1.50	
20000 TO 24999	10.06	657.97	midpoint	22,500.00	18.75	1.33	3,001.56
			endpoint	25,000.00	20.83	1.20	
25000 TO 29999	10.11	661.36	midpoint	27,500.00	22.92	1.09	3,662.93
			endpoint	30,000.00	25.00	1.00	
30000 TO 34999	8.30	542.56	midpoint	32,500.00	27.08	.92	
			endpoint	35,000.00	29.17	.86	
35000 TO 39999	5.91	386.64	midpoint	37,500.00	31.25	.80	
			endpoint	40,000.00	33.33	.75	
40000 TO 49999	8.14	532.48	midpoint	45,000.00	37.50	.67	
			endpoint	50,000.00	41.67	.60	
50000 TO 59999	6.33	413.77	midpoint	55,000.00	45.83	.54	
			endpoint	60,000.00	50.00	.50	
60000 TO 74999	6.07	396.82	midpoint	67,500.00	56.25	.44	
			endpoint	75,000.00	62.50	.40	
75000 OR MORE	9.23	603.70	midpoint	113,000.00	94.17	.26	
TOTAL	100.00	6,536.00				3,662.93	

SOURCE: Bureau of the Census Current Population Survey, November 1994.

Percentage of Income Plans (PIP) work the other way, precisely because they are intended to shield people from the burden of paying for necessities. They identify a percentage of income to be paid and require that households pay only that amount. They do not impose the average price on all households, regardless of income.

2. Proposals to Mitigate the Impact

a. Expansion of the Lifeline Program Leaves Many Low and Lower Middle Income Households to Bear the Full Burden of Rate Increases

SWB and several other companies also propose an expansion of the lifeline program to cushion some of the blow.⁶¹ But this provides little effective relief. SWB proposes a uniform national standard which would allow households below poverty to qualify for the program.⁶² This would increase the number of households eligible for lifeline in Texas. This would make approximately one million of the poorest households in the state eligible for assistance.⁶³

This does not provide relief for the working poor and lower middle class. There are another two million households who would be paying substantially more than one percent of income who would not be eligible for the program.

Even for those households that are eligible, the relief is less than appears at first glance.

- o These households would receive a waiver only for the federal subscriber line charge. No relief is offered for state rate rebalancing.
- o Participation in lifeline programs is quite low, so that many of the households who are eligible are unlikely to receive the benefits.

b. Revenue Neutral Rate Shifting Increases the Burden on Low and Lower Middle Income Households

Assurances have also been given that rate rebalancing will be revenue neutral in the aggregate.⁶⁴ These claims and promises should be looked at with a great deal of skepticism.

⁶¹ SWB, p. 7

⁶² SWB, p. 7.

⁶³ There are about 150,000 households in the state presently enrolled in telephone assistance programs (Texas P. 11).

⁶⁴ AT&T, p. 7; LIDS, p. 5; MCI, p. 13; SWB, p. i.